Subsidies And Industrial Competitiveness

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Abstract

It is aptly said that Subsidies should never be a permanent feature of any market. They should be introduced only to address market failure and they should be withdrawn gradually as those distortions in the market are addressed and any mismatch among these makes subsides a controversial topic due to several reasons like distorting trade and competition, futile use of funds but we can not ignore its positive aspects which promote welfare, innovation and research. Keeping these themes in mind, this paper 'Subsidies and Industrial Competitiveness' further discusses the impact and progress of incentives and their drawbacks along with the regulations by international organisations. The paper tries to cover various aspects related to the subsidies be it political agenda, growth process, welfare of the nation or any other economic strategy concerned. It lists the drawbacks and the challenges faced by

the subsidy-related schemes which hamper the growth process and burden the government with so many subsidy-related payments that distort the whole fiscal consolidation objective of the government.

Subsidies play a crucial role in a country like India as a support to small and medium enterprises and such practices go a long way in reducing unemployment figures which is the need for the country so that it stands up to the expectations of the mass population. Thus, to fulfil these objectives, it puts a strain on the public finances. For instance, the government is sponsoring a subsidy to a company manufacturing microns to be set up in Gujarat for assembling and testing chips. The budget of the project is equal to a quarter of India's budget used for higher education. This reflects the large monetary support that the government provides for the development.

To maximise the benefits, a proper balance between welfare and development needs to be achieved.

Methodology

The study employed the qualitative research technique and the data has been collected from various sites such as the International Monetary Fund, World Trade Organisation, interviews with ministers and newspaper articles. After mentioning the methodology used, the paper proceeds to introduce the subsidies and various other components related to that such as types, advantages, drawbacks, etc.

Introduction

Subsidies are the incentives given by the government to boost the production or exports of a particular sector and as a welfare scheme in case of food subsidies, education and rebates for people below the poverty line. Subsidies are used to correct the imperfections in the market and to attain the social welfare goals that are often overlooked by private players in the market. These days subsidies are also offered for promoting innovation and research-related tasks such as in the case of artificial intelligence and electric vehicles. But doling out subsidies by the government is often related to the coming up of elections and is becoming synonymous with gaining votes.

But subsidies if given with a proper objective and for a prospering sector can do wonders and can have a multiplier effect. These promote industrial competitiveness, bring innovation in the sectors and help industries create their global presence and expand their business worldwide. Subsidies also support incoming foreign direct investment in the nation which boosts the economic growth of the country.

Why do Governments use subsidies?

The government uses subsidies as a tool for increasing welfare and boosting economic activity in the nation as the government chooses a targeted segment of sectors for which various initiatives are taken. For instance, the Government of India came up with Production incentive schemes for boosting the manufacturing sector and the concessions in tax given to Special Economic Zones set up across the country help these sectors to grow which further contributes to the growth numbers of the country. These schemes are mainly pushed for achieving national strategic goals or gaining some international competitive advantage but it needs to be observed that not every time this decision is consciously taken as many times it can be either backed by vote bank politics which has become more famous as freebies or inexperience reflection of the ministers in handling fiscal payouts.

How subsidies impact business - Producers benefit vs. consumer

Subsidies help both producers and consumers in certain ways.

From the consumer point of view, they enjoy lower prices when the producer gets a subsidy from the government. So the price charged before the subsidy and after the subsidy becomes the consumer benefit. This directly leads to the consumer surplus and causes the demand expansion which is then dependent on the scale of the subsidy and price elasticity of the demand. Subsidies given for LPG connections come under this umbrella.

Producers prefer subsidies as financial support given by the government will generate extra profit and therefore improve the incentive to supply for the producer. He gets the market price in addition to the subsidy. They get a higher level of producer surplus and increased revenue. The producer benefit is the producer surplus earned before the subsidy compared with the producer surplus achieved after the subsidy. Incentives given to special economic zones can be cited as subsidies for producers.

WTO agreements - Types, Regulations and reforms, OECD Export- Credit Arrangements

World Trade Organisation has majorly bifurcated subsidies into three types which are[1]

[1] https://www.wto.org/english/tratop_e/scm_e/subs_e.htm

1. Amber Box- Subsidies under this box are deemed to be trade-distorting by encouraging excessive production through subsidies on fertilisers, seeds, irrigation and power. It has certain exceptions too. The Minimum Support Price (MSP) given to farmers on certain crops falls under this category.
2. Blue Box- The subsidies are tied to programmes that limit direction. In other words, even if they directly link production to subsidies, they also set limits on production by way of quotas. These cover payments based on acreage, yield or number of livestock in a base year.
3. Green Box- It includes those subsidies that do not distort trade and are given by the Government to compensate them for deficiencies in the agricultural environment. Green Box subsidies are allowed under the Agreement on Agriculture with no prescribed limit. It includes environmental protection and regional development programmes. Limits on wastewater discharge and pollution control limits are examples.

The Agreement on Subsidies and Countervailing Measures (SCM Agreement) by the World Trade Organisation addresses the multilateral disciplines regulating the provision of subsidies which covers the dispute settlement procedures and the use of countervailing measures to offset injury caused by subsidised imports.

The Organisation for Economic Co-operation and Development (OECD) has also credit arrangements related to exports which act as a level playing field and help foreign buyers defer the payment for some time.

Major Subsidies in India

As per the "Statement on Subsidies and Subsidy Related Schemes"[2], the Government of India offers the following subsidies:

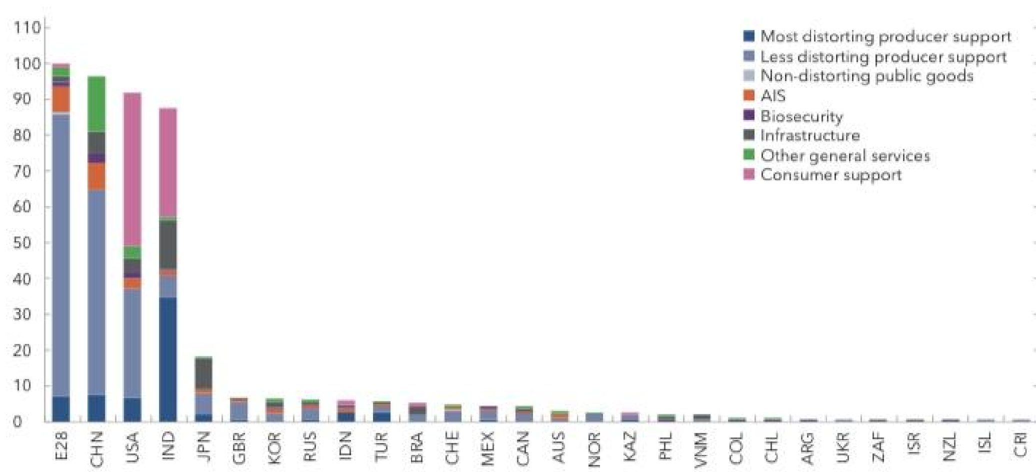
1. Food Subsidy
2. Fertiliser Subsidy
    a. Nutrient Based Subsidy
    b. Urea Subsidy
3. Petroleum Based subsidy
    a. LPG Subsidy
    b. Direct benefit transfer- kerosene
4. Interest Subsidy
5. Other subsidy

[2] STATEMENT 7 STATEMENT ON SUBSIDIES AND SUBSIDY ...

The Grand Total Budget Estimate for the year 2023-24 is ₹403083.63 Crores.

Agriculture subsidies and related issues

Agricultural subsidies constitute the most common subsidies, especially in India but subsidised rates and other schemes have not reflected the planned trajectory of growth as compared to the other sectors. But India has achieved some tremendous milestones since independence like becoming self-sufficient in the production of food grains and now attaining the position of the largest exporters in the world in specific crops. On a world level, various agricultural subsidy issues persist and even after considering the agriculture under rule-based trading system in the Uruguay Round Agreement on Agriculture, this sector remains highly distorted even now. It can be analysed from the budgetary support to agriculture among different nations, Gross farm receipts (GFR) of the European Union, United Kingdom, China, United States and India accounted for USD 376 billion of the USD 447 billion per year in 2018-20 which is shown in the below graph.



These days, a shift is required from the traditional pattern of crops to crops as per the need and climate of that place so that it helps the farmers in increasing their income. Moreover, farm laws that cover the aspirations of the farmers and related parties should be introduced so that this sector can gain high heights.

A complaint was filed by Australia, Brazil and Guatemala against India on account of giving sugar subsidies as the countries alleged that the subsidies given by the Indian government violated the rules stated by the World Trade Organisation. The WTO ruled against India and asked it to withdraw its prohibited subsidies under the Production Assistance, the Buffer Stock and the Marketing and Transportation Schemes as the dispute panel found out that from 2014-15 to 2018-19, India Provided subsidies over its limit.

In June 2023, India and the US agreed to end six trade disputes at the World Trade Organisation while New Delhi will also remove retaliatory customs duties on 28 American products such as almonds, walnuts, and apples according to an official statement but contradictory views exist on wheat and rice subsidies because as per the United States, it is inconsistent with the WTO regulations.

Similarly, many issues like the above are presented before the World Trade Organisation for settlement. So, it's time the nations and the WTO find a way so these cases are reduced to pave the way for smooth global trade practices. WTO is in the process of planning to execute reformed policies which the organisation feels will bring transparency. Understanding the impacts of the policies would play an essential role in subsidy reforms. Besides that analysis needs to be performed, for instance, if a lower-income country is bringing subsidies to correct the market failures, it needs to be informed of the repercussions that it may have to go through in that process. These incentives need to be carefully designed so that it doesn't harm the trade practices at domestic and international levels and the governments of respective nations need to avoid taking aggressive actions. Cooperation is the key to achieving determined gains. Besides that international organisations such as the IMF, OECD and the World Bank are at the service of providing guidance and strategies for the member nations so that they make the right decisions with the available information and resources.

The economists believe that India needs to reduce its subsidies on agriculture, fertilisers and fuels and work on its infrastructure as it will help the country achieve a high economic growth rate.

Energy Subsidies

Energy subsidies that cover fossil fuels (coal, natural gas and oil products), electricity and heat generation based on such fuels have always grabbed prominent attention as it has not only contributed to large fiscal deficits but also to negative externalities such as water and air pollution to a large extent. Nothing major reforms have been taken as they directly impact the trade process. As per the recent figures given by the International Monetary Fund, fossil fuel subsidies have surged to new record heights worth US$ 7 trillion. To reduce the dependence on fossil fuels and also ensure long-term availability, nations are betting high on renewable sources of energy and thus promoting the same by giving subsidies so that those particular industries could get a good head start. India's energy subsidies have fallen by 59% since 2017 and this fall is significantly important to come nearer the decarbonisation goals of 2030 as promised. The focus needs to be shifted to cleaner fuels for cooking as well and for this short term, LPG subsidy won't be an issue so that the economically marginalised societies don't suffer keeping in mind the long-term sustainability. Electric vehicles are a great step to reduce dependence on traditional fuels and initiatives by the government as they help in converting around 60% of the electrical energy from the grid to power the wheels, but petrol or diesel cars can only convert 17%-21% of the energy stored in the fuel to the wheels. Further improvements in the sector can be really beneficial in cost-cutting practices especially the transportation costs which will help the business gain more. But a decrease in the number of subsidies for electric vehicles as decided by the government may pose some challenges for the sector and decline in adoption of the vehicles as they are in the initial phase now and some aspects such as distance coverage and catching of fires by some EV vehicles have already raised concerns among the consumers. Power subsidies are given by many states, especially for agriculture and specific industries but some Punjab and Delhi also give subsidies on the bill of the units consumed are in the specific limit as set by the government and the consumers get their bill waived off but this robs the state of the major revenue opportunity.

Progress of Production Incentives

The contribution of the manufacturing sector has been more or less stagnant for a decade now around 14% of the Gross Domestic Product (GDP) and to increase the contribution, various bigger initiatives like Make in India and Atmanirbhar Bharat have not been able to attract the desired results. So, the government came up with a new scheme known as Production Linked Incentives. This scheme is playing a crucial role for the sector. It is helpful for the sunrise sectors as they need support in the initial stages. It will lead to the diversification of the export base and the scheme will make India a major player in the supply chains.

The first round of the scheme was successful in enhancing investments in the sector related to mobile phones, and manufacturing of electronic components and the second round of the scheme would be majorly focusing on the specified electronic components.
The scheme shall extend an incentive of 4% to 6% on incremental sales (over base year) of goods manufactured in India and covered under target segments, to eligible companies, for five (5) years after the base year as defined.

But for the fulfilment of the goals stated by the schemes, certain challenges need to be addressed which cover inadequate funds allocation, especially to the IT hardware sector to which the Ministry of Electronics stated that specific funds are issued under the budget but after assessment, they could cater to the demand. Moreover, supply chain disruptions and geopolitical tensions also hamper the trade like in the case of semiconductor chips. Apart from that, the manufacturing sector has not been able to jump into the growth momentum due to less demand and low subsidies. This is to be noted that only specific sectors are covered under this scheme but they are also lagging due to deficient demand. The government needs to look into the matter and need to make changes to the business environment. All in all it's a great step but the journey is long which is a grand achievement of welcoming Apple in India.

The major reasons why the economists are divided into two viewpoints for this scheme are the unmet objectives laid under the scheme and the potential of the scheme to outperform. The challenges that obstruct the growth of the initiative include:

1. Different states have their policy regulations which complicate the regulation process and thus become the hurdles for a smooth functioning of the process.
2. High capital and operational costs also affect the success rate and it also widens the infrastructural gaps.
3. No doubt, India boasts one of the largest working forces but the proportion of skilled labour to the population is quite less due to which mass job creation is also not possible.
4. Geopolitical factors and structural changes in the economy result in trade restrictions, and fragmented supply chains also hinder the growth process.

Apart from that economists also argue that the focus on selective sectors under these schemes will affect the allocation of resources and promote an uneven competitive space. The financial burden on the government will deteriorate the fiscal health of the nation.

Raghuram Rajan, the former Reserve Bank of India Governor has also raised many concerns about the PLI scheme and raised inefficiencies. According to him, instead of just finishing the product in India, subsidies should be given based on the value added in the manufacturing process and that will help more as to finish a product in India, one imports a lot of sub-products.

On the competitiveness aspect, it will make the domestic firm competitive due to reduced compliances, financial availability investment through Foreign direct investment and foreign portfolio investment, it will boost the production both in terms of quality and quantity and will make the firms globally competitive.

Thus, for a successful policy outcome, the government should focus on developing quality infrastructure that will enhance the growth process. The focus on skill education and continuous upskilling should be there so that the workforce can deal with the dynamic business environment. Research work should be highly valued as that would promote innovation. Free trade agreements should be effectively used so that domestic firms can take advantage of international developments.

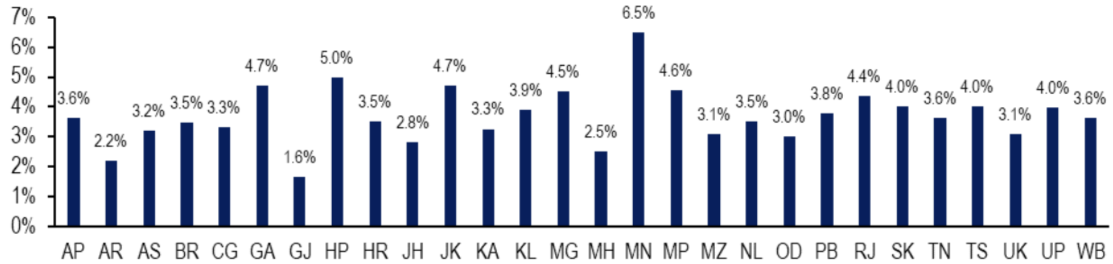
Trade barriers need to be reduced and export activities need to be strengthened so that the manufacturing sector can reach its potential and our domestic firms aim to reach the global competency level.

States and Subsidies: Which state has the highest subsidy load?

As there exists different governments in different states of our country, these governments have their way of favouring voters on their side and one of the best ways is giving subsidies which no doubt turns out to be a success in terms of vote share the majority of the time. But the sad truth is that these governments sacrifice long-term economic gains over short-term wins and pave the way for fiscal imbalances which further result in hindering the development process. As per the Reserve Bank of India, the state's expenditure has grown by 12.9% and 11.2% in the financial year 2021 and 2022 respectively. This is attributed to the fact that many subsidies are non-merit subsidies which don't contribute much and burden the state with loans. As we analyse the data from 2018-19 to 2020-21, Delhi witnessed an 85 per cent increase in the subsidies bill. Among all the subsidies, power subsidy is the most common one and is led by states such as Punjab, Rajasthan and Madhya Pradesh. The following graphs represent the power subsidies given by various states as a proportion of revenue receipts for the year 2019-20.

Sources: Report on Performance of Power Utilities for 2020-21, Power Finance Corporation; CAG; State Budget Documents; PRS.

The fiscal deficit of various states as per the budget estimates as a percentage of Gross Domestic State Product(GSDP) is shown below.



Note: Delhi, Puducherry, and Tripura not shown in above chart as 2022-23 GSDP estimate not available for them.

Sources: State Budget Documents; PRS.

After power subsidies, LPG subsidies are very common and states having large agricultural land also give fertiliser and related subsidies to the farmers. The Rajasthan government gives cylinders at ₹500 and when questioned then Rajasthan Chief Minister Mr Ashok Gehlot asked the media not to compare that with freebies and listed the positive aspects of the same. Similarly, other states also have a long list of subsidies.

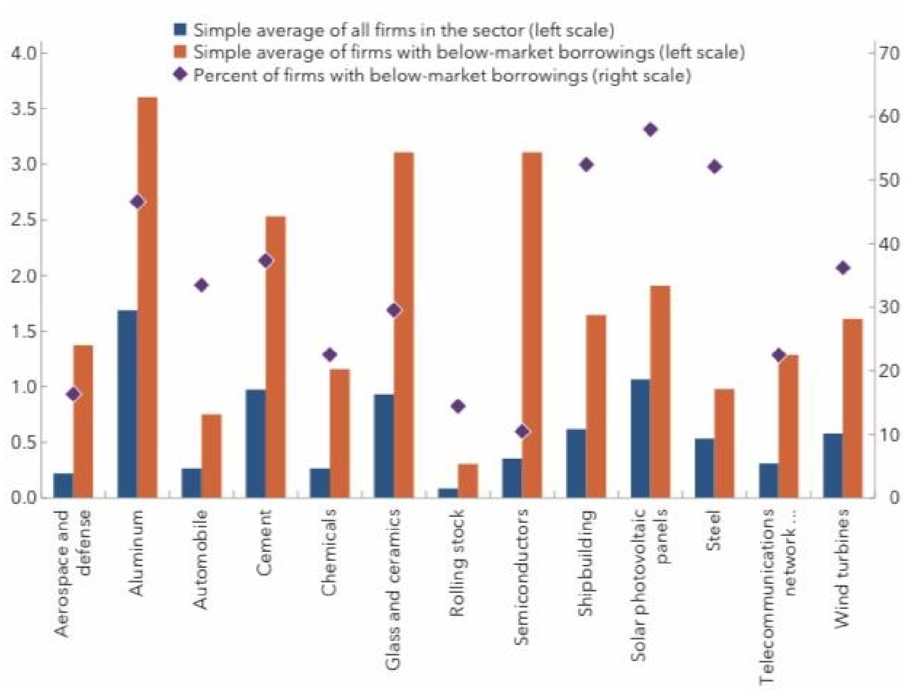
Effects of subsidies on competition and trade

The subsidies besides boosting growth for specific sectors are also responsible for distorting the competition because of some beneficial treatment given to them which acts as an undue advantage for them. It motivates other players for illegal means when one of their competitors is doing the same in the case of taking false subsidies by electric vehicle manufacturers in India. This doesn't send good signals to Organisations working hard day and night and adopting legal means to earn profits. Governments should keep this thing in mind so that their schemes don't distort the cycle.

Government intervention doesn't necessarily bring positive outcomes as according to the IMF economists the world could have reduced air pollution deaths by air pollution the policymakers could have reduced it by 46 million if they had considered replacing the fossil fuel subsidy schemes.

India being one of the largest emitters of greenhouse gases, is also worried about the huge subsidies given by developed nations for green hydrogen as it may lead to distorting trade and are also violating the World Trade Organisation regulations and thus wants the WTO's intervention for the same.

Effective competition policies are required and they should be aligned with the contemporary realities of the nation. Other challenging factors are the cost of doing business and reforms in the sector due to which small and medium enterprises face issues to scale their production. The government is working on the same and also uses the tool of below-market borrowing for industries through which they get loans at a subsidised rate i.e. below the set market rates. This reduces the cost of borrowing for the firms and helps them to raise profits. The data relating to the below-market borrowing is shown below. It also represents that heavy industries tend to benefit more through below-market borrowings.



Source: OECD (2021b).
Note: Blue bars count below-market borrowings as zero for companies that exceeded the benchmark (i.e., companies that paid more interest than the benchmark). These firms are dropped altogether when calculating the orange bars. The calculations are based on firm-level data, with coverage ranging from 25 to 75 percent of global sales, output, or capacity, depending on the sector.

Moreover, the cons of giving subsidies on the nation's future development perspectives and especially the opportunity cost should be analysed properly before rolling out the schemes. For politicians, subsidies are an easy tool for diverting attention to important areas and retaining a vote bank and they are ready to sacrifice long-term gains over short-term objectives. Direct benefit transfers are effective especially when dealing with marginalised sectors and sections of society, as it reduces other costs and benefits to the ultimate consumer. Subsidies are also a hindrance to the growth of the economy as the funds that can be used for other high-potential sectors such as education, health etc. are used for other purposes which are mostly as a transfer payment or a low-growth model. Thus, all subsidies are not bad and it all depends on their objective and long-term commitment.

Analysing Research and development subsidies about innovation and technological advancements

There is no iota of doubt in the fact that subsidies motivate businesses and research for innovation and new developments as the government is backing them. Moreover, they are satisfied with the fact that they can struggle with some years of losses for the long-term impact that they are trying to achieve.

Currently, Electric Vehicles are being promoted because of their huge potential as the size of the electric vehicle market in India is ₹7.5 trillion and it will reach ₹16 trillion by 2030. Thus the government wants to seize this opportunity and is creating opportunities and schemes for the same. National schemes such as Atal Innovation Mission and Innovate in India which is also sponsored by the World Bank are promoting innovation and entrepreneurship and defining a good subsidy environment.

The Faster Adoption and Manufacturing of Electric Vehicles (FAME) is one such subsidy scheme launched in 2015 by the Government of India for the promotion of production of some parts or whole in India encouraging innovation and manufacturing facilities in the country, thus motivating citizens to prefer for a clean and greener source of energy as compared to the fossil fuels. FAME II was launched in 2019 and it will be active till the end of this financial year but it attracted a round of controversies when the two companies Hero Electric and Okinawa Revolt were found flouting rules just for the sake of availing the subsidy amount. Moreover, the case of four-wheeler electric vehicles by Ola, Ather, TVS Motor and Vida were taken under the radar and it was found that these companies were involved in wrongfully claiming a subsidy of at least ₹300 Crores.

This situation reflects the reason why governments shy away from larger subsidies as at first these schemes put pressure on the fiscal balance of the government and secondarily they promote illegal behaviour among the targeted sector.

The positive aspect is that schemes like Startup India, policies for Small and Medium, and FDI attraction pave the way for the creation of competitive firms on which our country is doing great work.

Way Forward

Thus, it is clear that subsidies have both pros and cons but it depends on the nation's economic strategy which will guide the reform process and analyse their implementation properly. So, initially, the use and requirement of a particular subsidy scheme should be cleared so that it doesn't cause a waste of public resources and harm the competition cycle. On a world scale, all countries need to come together so that the subsidy-related schemes don't damage the competition and needed reforms can be implemented. To mitigate the drawbacks one has to analyse the fears and gains properly. For output-related subsidies in sectors like agriculture, they should be properly targeted and adequate evaluation and monitoring should be done as it will help in gradually phasing out the subsidy support to let the industries adjust themselves to the dynamic environment and become self-dependent.

Moreover, there exists a constant tussle for the government while deciding to choose between Subsidies and high import tariffs as the former fulfils the purpose of welfare and development, and the latter is responsible for high revenue for the government. So to seize the benefits of both opportunities, policymakers should take steps taking the present circumstances and potential of the sector in mind.

The present and future roadmap should be directed towards competitiveness-based policies and sector-specific inclusive policies. Public-private partnerships can be strengthened which will lower the burden on the state keeping the development pace higher. There must be coordination among different policies and the sunset clause should be followed to be on the right time track.

To sum up, subsidies should be based on economic growth which should be matched by social progress, a sustainable environment, solid economic performance and shared economic opportunities.

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